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SIPDIS

TREASURY FOR INTERNATIONAL AFFAIRS - MNUGENT

SENSITIVE
SIPDIS

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SUBJECT: Turkish Government Pulls Back Controversial Investor Tax

Ref: A) Istanbul 392; B) 2005 Ankara 4494

¶1. (SBU) Summary: In a bid to calm bearish financial markets, the Finance and Economy Ministers announced June 21 that the Government was eliminating the controversial 15% withholding tax on foreign investors' earnings from bonds and equities, while reducing the rate on domestic investors from 15% to 10%. The withholding tax was cited as one of the factors causing the global sell-off to hit Turkey harder than other Emerging Markets. Although market analysts praised the move, the Turkish press criticized the differentiation between foreign and domestic investors. The measure failed to stop a resumption in the lira's slide, leading to a Central Bank intervention June 23. The Government's u-turn is also a success for USG advocacy: the Ambassador had advocated on behalf of U.S. companies whose offices in Turkey were losing business due to the tax. End Summary.

Finance and Economy Ministers Announce Surprise Pullback on Withholding Tax...

¶2. (U) On the morning of June 22, in a joint press conference, Finance Minister Unakitan and Economy Minister Babacan announced that the Government is submitting legislation to parliament to eliminate the withholding tax levied on foreign investors' earnings from equities and bonds. The 15% tax will remain for deposits and repurchase agreements (repos). For domestic investors, withholding on equities and bonds will be retained, but the rate will be reduced from 15% to 10%. Unakitan vowed to pass the legislation before the summer recess (due to start July 1) and the legislation passed Parliament's Budget and Planning Commission on the day of the announcement.

.. in an attempt to Reassure Falling Markets

¶3. (SBU) Though Unakitan attempted to spin the move as conforming to EU taxation norms, the Government was clearly concerned about sliding markets. The withholding tax had long been controversial with foreign investors and financial houses, which began complaining to the Embassy a year ago, as the GOT prepared for the January 1, 2006 implementation of the withholding tax law. The law was intended as a reform, equalizing taxation across all types of financial instruments while it also, in theory, equalized treatment between foreign and domestic investors. In practice, many market contacts argued it was discriminatory to foreigners, who are not subjected to these kinds of withholding taxes in other Emerging Markets, and would have to institute cumbersome tracking and tax filing procedures, whereas domestic investors were already filing Turkish tax returns. In what the GOT hoped was a compromise that

would mollify foreign investors, the GOT watered down the original measure by exempting derivatives when it implemented the tax at the beginning of 2006.

¶4. (SBU) Although the markets seemed to shrug off the introduction of the new tax in January, when Emerging Markets sold off in mid-May, analysts cited the tax as one of the reasons Turkish markets fell more than other markets. The GOT seems to have been spooked on June 21, when the exchange rate fell even though global markets were up. The IMF Deputy Resrep confirmed the Fund had been consulted on the move, but only at the last minute. The Fund is studying the revenue impact from the elimination of the tax but doubts it will be significant, particularly in 2006. Adding to the sense of GOT focus on markets was Babacan's presentation which recapped the GOT's accomplishments, reminding investors that approval of the third and fourth reviews under the IMF program was imminent. In a sign of the urgency the Government has assigned to rescinding the tax, the legislation has already cleared Parliament's Budget and Planning Commission, and the head of the Tax Administration announced that the implementing regulations will be prepared such that the changes will be effective from the date they are announced in the Official Gazette - a lightning speed implementation compared to other measures.

Sell-off Continues

¶5. (SBU) Although markets briefly turned upwards following the announcement, they soon resumed their descent, particularly the beleaguered foreign exchange market. Having fallen from 1.6166 per dollar to 1.6493 on June 21, the lira ended the day June 22 at 1.6687 and continued falling at the opening June 23 to 1.7036 at mid-day. The continuing descent of the lira on June 23 brought the

Central Bank back into the market with its second intervention since Turkish markets started falling six weeks ago. Although the reasons the for the severity of the sell-off in foreign exchange markets remain somewhat mysterious, analysts believe the bearishness reflects some combination of increased anxiety about domestic politics, inflation worries, lack of confidence in the new Central Bank team, concerns about the EU process, and, of course, a global flight to quality. There are also new fears that some market operators are speculating against the lira.

Praise from Analysts, Criticism from Press

¶6. (SBU) Market analysts generally praised the GOT move as a positive market surprise that, over time is likely to render Turkish equities and bonds more attractive to foreign inestors. In particular, it may help Turkish Teasury to resume issuing some of the longe-dated lira-denominated bonds, thereby helping to lengthen the average maturity of treasury det. Though some analysts noted the measure was unlikely to be powerful enough to turn around market sentiment, it was still a market-friendly move. The head of Raymond James/Istanbul told us the elimination of the withholding tax is also likely to bring back brokerage business that had moved to London. It is also likely to help the American Depositary Receipt business which was threatened with extinction by the withholding tax.

¶7. (SBU) The Turkish press, on the other hand, tended to be negative in its coverage, focusing on the differential treatment between foreign and domestic investors. The mainstream daily Sabah was particularly harsh, comparing the decision to the reviled Ottoman-era "capitulations" to western interests. The differential treatment has raised concerns that President Sezer, or the courts, could strike down the law. As one analyst noted, however, in that case the GOT would simply eliminate the tax altogether, keeping the regime investor-friendly.

A Success for USG Advocacy

¶8. (SBU) The USG played a role in encouraging the GOT's decision. While we did not support a specific action or solution, we have been consistently advocating on behalf of American business interests that were negatively affected by the advent of the withholding tax. The Ambassador raised the issue with the Minister of Finance in April, and followed up with a letter June 16 passing on a presentation that the U.S.-based brokerage Raymond James had made to Turkish Ambassador to the U.S. Nabi Sensoy. The letter noted Raymond James' arguments that the tax drove brokerage business offshore, hurting companies that had made direct investments in Turkey, and drove away needed portfolio investment. Raymond James' U.S.-based executive responsible for the company's Turkish business, thanked the Embassy for our role.

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